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INSIGHTS

"Insights" features the thoughts and views of the top authorities from academia and the profession. This section offers unique perspectives from the leading minds in investment management.

PHASE SHIFTS

*Dean LeBaron**

The physical world is composed of phase shifts, and we generally accept and understand the implications. The failure to recognize a phase shift that has taken place is exemplified by the perception of investment people about where they stand in the world … even what they stand for. I was part of the first AIMR group to embrace performance standards that implies phase shifts do not take place.

We complain about fair disclosure thinking it might inhibit access, but access comes at the price of acquiescence, a coin of our clients that we have been willing to pay for them. We should be willing to adopt high standards of personal behavior, such as classifying ourselves as insiders with respect to our personal investment accounts.

The physical world is composed of phase shifts, and we generally accept and understand the implications. At different temperatures, for example, H_2O can exist as solid ice, water, or steam, and each has dramatically different properties. However, as we know from our junior high school general science classes, the material structure of H_2O can differ dramatically at the exact same measured temperature—at 0°C, H_2O can be both water and ice, and at 100°C it can be both water and steam. These two inflection points produce major phase shifts.

Investigators of social systems, including those studying financial markets, have great difficulty recognizing phase shifts in their own fields. Often, they simply do not see those changes that affect them most dramatically. Our psyche rejects the trauma that change brings. We cling to our charts of even units of time marching from left to right across the x-axis; we accept direction as a given and elevate hindsight thinking to the science of data mining.

The failure to recognize a phase shift that has taken place is exemplified by the perception of investment people about where they stand in the world … even what they stand for. Our organizational structures function as "business as usual" repeating the same mantras of decades ago, even paying for ads to repeat them when journalists conclude that these shibboleths no longer fit the data. The very people who are charged with dispassionately serving others have, in the nearly unanimous opinion of clientele and academic researchers, failed to fulfill their mandates.

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We have entered, rushed into, a phase of external regulation replacing individual and collective self-regulation. We repudiate conflicts of interest as if we can sweep them away with a broom and a paycheck, and we tap the wrists of a few for the failings of all of us to recognize that things really are different … and have been for a while.

I was part of the first AIMR group to embrace performance standards. If performance standards were good for firms, would they not be good for each of us, the vendors of investment services? When the attorney general of New York State announced that the Institutional Investor First Team (during a dinner honoring them) produced investment results no better than the average investment analyst, shouldn't we have a defense? Should we not have individual performance standards? We won't. Instead we have lawyers who say "don't" when we wish to express an opinion before all possible financial minefields have been checked and cleared.

We complain about fair disclosure thinking it might inhibit access, but access comes at the price of acquiescence, a coin of our clients that we have been willing to pay for them. We could favor financial disclosure with very simple internet solutions that are cheap and fair to all. Instead we use our handy rear view mirror.

In the earlier phase of investment practice we accepted certain dubious conventions as ordinary. Like the use of soft dollars in ways in which we would not spend our own hard dollars; like hidden proxy votes for the interests of the managements who hire us but perhaps against the shareholders we are charged to protect; like the acceptance without challenge of material presented to us by listed companies since to do otherwise could sever a communication pathway considered essential for our livelihood.

Our clients consider us overpaid, under worked, light headed, and untrustworthy. To refute these charges, a repeat of old slogans will merely confirm that we do not apply to ourselves the strict discipline standards we espouse for others. When we are confirmed as a value-reducing group of merchants with an analytical/reportorial cast, we must radically reform to regain the stature we once held. Even the SEC now demands that investment opinions we sign be specifically confirmed to be our opinions … as if they could be otherwise. Reform will be painful but there is no alternative in the new, harsh phase.

What are the steps? First, to recognize that things are different and that the criticism is often correct. Second, to promote transparency in everything so we, and others, can study ourselves, learn, and correct. Third, to adopt high standards of personal behavior, such as classifying ourselves as insiders with respect to our personal investment accounts. (I am in favor of allowing more insider trading to encourage price discovery of the insiders' information but would require insiders to identify themselves as such before trading.) Fourth, to publicly punish transgressions … hard and fast. Fifth, to demand that all of us, trustees of the interests of others, provide frequent evidence when we have aided our clients to our own personal detriment. Sixth, to utilize the power of the web to encourage investment people to maintain a log, so clients can publicly note their favorable or unfavorable experiences with us. Seventh, to drive down investment costs of every form. Our inability to use simple technology is embarrassing, at a minimum.

It may be too late. Our inability to recognize the radical changes—the phase shifts—has, thus far, prevented our leaders from participating in the selection of remedies. And we can remain, as currently seems to be our course, on the old paths that lead to nowhere. Or we can try, if only for our own pride and self-respect, to catch up on the new path, to control events that will produce the best result for our clientele … and ourselves.

I hope for the latter.